Testimony of the Honorable Glenn English, CEO
National Rural Electric Cooperatives Association

Before the
United States House Energy and Commerce
Subcommittee on Energy and the Environment

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Mr. Chairman, it is an honor to appear before this subcommittee. I thank you for this opportunity to share rural electric co-ops' perspective on the potential negative effects of the Over-the-Counter Derivatives Markets Act of 2009 (H.R. 3795) on our electricity and natural gas markets.

I think it is important to note that Agriculture Committee Chairman Collin Peterson (D-MN) has done a good job putting together derivatives legislation that will go a long way toward increasing transparency and reducing systemic risk, while allowing "end-users", like the rural electric co-ops, to continue to hedge commercial business risks in a cost-effective manner. Chairman Peterson has worked diligently to prevent these reforms from being accompanied by unintended negative consequences. In that spirit, I will share with the subcommittee how the critical transactions in our electricity and natural gas markets could be inadvertently jeopardized if certain modifications are not made to this legislation.

As most of you know, the National Rural Electric Cooperative Association (NRECA) is the not-for-profit, national service organization representing nearly 930 not-for-profit, member-owned, rural electric cooperative systems, which serve 42 million customers in 47 states. NRECA estimates that cooperatives own and maintain 2.5 million miles or 42 percent of the nation's electric distribution lines covering three-quarters of the nation's landmass. Cooperatives serve approximately 18 million businesses, homes, farms, schools and other establishments in 2,500 of the nation's 3,141 counties. Cooperatives still average just seven customers per mile of electrical distribution line, by far the lowest density in the industry. These low population densities, the challenge of traversing vast, remote stretches of often rugged topography, and the increasing volatility in the electric marketplace pose a daily challenge to our mission: to provide a stable, reliable supply of affordable power to our members—including your constituents. That challenge is critical when you consider that the average household income in the service territories of most of our member co-ops lags the national average income by over 14%.

Mr. Chairman, we are concerned that the legislation could inadvertently make it difficult and/or much more expensive for an electric generation and transmission co-op to buy power in a Regional Transmission Organization (RTO) market, or even to buy and deliver the energy and capacity they need to serve their own members in RTO regions. RTOs are independent operators of the high voltage electric power grid and are responsible for providing open access transmission service and ensuring the reliability of the transmission systems they operate. Most RTOs also operate real-time and day-ahead markets for electric power. These markets establish locational marginal prices (LMPs) for energy, based on the bid price of the last unit dispatched to meet load in the RTO region.

The level of congestion in different parts of the transmission system can and does change regularly. Therefore, the cost of power consumed in any part of the system can be extremely volatile. That volatility is challenging for utilities because the LMPs not only establish the cost of power for utilities buying energy out of the market at a particular location, the LMPs also establish the cost for utilities with their own power resources to transmit power from those resources on one part of the system to their consumers on another part of the system. Utilities are paid the LMP price for energy they generate at one point of the system and then pay the LMP price for energy at the point where it is withdrawn to serve consumers. Thus, changes in the LMP at either the "source" of the power or the "sink" change the cost of delivered power due to congestion costs incurred in delivery.

In order to help utilities hedge these risks and manage costs, the Federal Energy Regulatory Commission (FERC) requires RTOs that operate real-time and day-ahead LMP markets to make "financial transmission rights" (FTRs) or "congestion revenue rights" (CRRs) available to market participants. FTRs and CRRs are financial instruments that entitle holders to congestion revenues from a particular transmission path. These FTR revenues help offset the costs incurred by utilities to deliver energy over the congested transmission paths.

For example, if a utility that must move power from point A to point B owns the FTR from A to B, then their obligation to pay congestion costs between A and B is offset in part or in whole by their right to recover the congestion revenues over that same path. These FTRs and CRRs are absolutely essential for electric cooperatives and other load serving entities (LSEs) within RTO regions. Without these hedging tools, it would be much more risky and much more costly for LSEs to manage their resource portfolios and deliver power to their consumers. These tools are so important to the efficient and reliable planning and operation of the electric grid that the Energy Policy Act of 2005 directed FERC to ensure that all LSEs have access to the long-term FTRs they need to meet the long-term needs of their electric consumers. LSEs need the long-term certainty offered by long-term FTRs in order to invest in the long-lived, capital-intensive assets such as power plants (50+ year assets) and transmission facilities (30+ year assets) that are needed to provide reliable electric service.

RTOs and the other bilateral contract (the "over-the-counter" or "OTC) markets have also supported investment in generation resources through active capacity markets. RTOs manage auctions and the secondary purchase and sale of "capacity" contracts, which commit the seller to provide a generation resource if the RTO calls on the seller to provide power to the grid in its region. The markets in such capacity products, whether run by the RTOs or the bilateral OTC contract markets, enable electric companies to meet their reliability obligations to the grid operator and encourages infrastructure development. Investors are provided the revenue stream they require to ensure they recover their costs and provide buyers with the certainty that the power they need to serve consumers will be available when they need it. It should also be noted that it is common for electric co-ops to have long-term purchases of capacity rights and physical energy "bundled together" in a single contract at a single price to economically meet its needs for both RTO requirements.

In some ways, these FTR and capacity contracts are the economic equivalent of financial derivatives or "swaps" under the new legislation. Rural electric co-ops are concerned that the proposed legislation could impose duplicative and costly regulation on RTOs and jeopardize contracts for both FTR and capacity markets.

The RTOs created the FTR and RTO-based capacity contracts, and the Federal Energy Regulatory Commission (FERC) comprehensively regulates all jurisdictional wholesale sales and jurisdictional interstate transmission service, pursuant to the Federal Power Act, as an integral part of the overall electric market structure focused on reliability. Sections 205 and 206 of the Federal Power Act give FERC authority to ensure that the rates, terms, and conditions of all jurisdictional wholesale sales of power and all jurisdictional transmission in interstate commerce are just and reasonable. In order to fulfill that duty, FERC has required RTOs to file tariffs at FERC governing every aspect of their markets. The design, operation, and governance of RTOs, the products sold in RTO markets, the mechanisms for setting prices in those markets, the financial rights and obligations of parties who participate in the markets, and the means the RTOs use to monitor the markets for market power and market manipulation are all filed at FERC and subject to FERC review and oversight. The FTRs and RTO capacity markets that are at issue here were created by RTOs at FERC's direction, according to standards established by FERC, and are bought and sold pursuant to FERC-filed tariff. Mismanagement of the markets by the RTOs and misconduct in those markets by participants are both subject to stiff penalties from FERC.

H.R. 3795 purports to give the CFTC "exclusive jurisdiction" over all derivatives, or "swaps" (other than securities-based swaps), without recognizing FERC jurisdiction, much less FERC exclusive jurisdiction, over wholesale electric transactions and transmission in interstate commerce. This bill therefore purports to subject all "swaps" to the provisions of the Commodity Exchange Act or "CEA."[1] The legislation proposed by the Treasury Department, the House Financial Services Committee and the House Agriculture Committee all do this by simply eliminating the swaps exemption from the CEA, and eliminating many of the other exemptions which have allowed the OTC energy derivatives markets, of which the RTO markets are a part, to develop without CFTC jurisdiction.[2] Instead, the bill adds the term "swap" to many of the sections of the CEA, and then defines "swap" broadly in a proposed new provision of Section 1a of the CEA.

The term "swap" is essentially defined as: 1) an option on virtually anything, 2) any transaction dependent upon the occurrence or non-occurrence of a wide variety of events or circumstances or providing for an exchange of payments based on virtually anything, or 3) any transaction that is "commonly known" as a swap. The definition is very broad and could be read to authorize the CFTC to regulate all OTC derivatives transactions in the same way. Although H.R. 3795 includes a list of exclusions from the definition of "swap" and exemptions from other provisions, none of the exclusions or exemptions appear to fit the FERC-regulated RTOs, RTO markets and RTO products.

We are concerned that the CFTC does not have the same regulatory experience with power and transmission markets that FERC possesses. The CFTC does not have the same regulatory priorities – reliability and just and reasonable rates for electricity, and it does not routinely recognize, in its market regulation, the financial issues facing entities like NRECA's members,

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[1] See proposed changes to Section 2(a) and 2(c) of the CEA in Section 102 of H.R. 3795

[2] See Section 103 of the H.R. 3795 that eliminates CEA Sections 2(d), 2(e), 2(g) and 2(h) entirely

who may have lesser financial credit metrics than some financial institutions, but who nonetheless have to participate in the RTO power markets. In recognition of these differences in market participants' financial credit quality, the RTO credit support mechanisms are structured to allow NRECA members to participate without the costly capital and margining rules applicable in other commodity markets. The RTOs, their markets and their products are structured to achieve FERC's and the RTOs' regulatory priorities, and to enable the LSEs to serve their customers and hedge their commercial business risks. Therefore, if the CFTC were the primary regulator of the RTO markets or products, there could be reliability problems caused by a different approach to market structure, and there would almost certainly be significant administrative and margin and credit costs for NRECA members.

NRECA is also seeking clarification in the bill of the "physical transaction" exclusion from the definition of swap. Many physical forward electric and natural gas transactions are entered into with the intent of physical delivery, but are "booked-out" before delivery, for scheduling efficiency. These transactions are already regulated by FERC and subject to extensive record-keeping and reporting requirements and should not be subject to additional or inconsistent regulation. It is important to clarify the "physical transaction" exclusion to the definition of swap so the bill does not unintentionally put such transactions within the domain of CFTC derivatives regulation. If not addressed in the bill, this new regulation could subject physical natural gas or power transactions to duplicative, costly new regulation. Those administrative burdens and costs would be borne by NRECA members.

Mr. Chairman, in short, I believe FERC should keep its exclusive jurisdiction over RTOs. RTO markets and RTO-created products are integral to the RTOs' regulatory reliability mission. FERC should also maintain its jurisdiction over physical forward natural gas and power transactions, whether or not those transactions ultimately result in physical forward delivery or are "booked out," and over bilateral OTC capacity transactions. However, the CFTC should be able to maintain its current market manipulation authority over the bilateral OTC natural gas and power markets. Finally, we request that the two commissions remain disciplined in meeting the harmonization of legislative goals by entering into a memorandum of understanding and reporting back to Congress periodically on the ways in which the CFTC is using its authority to avoid, reduce or eliminate duplicative and inconsistent regulation.

Mr. Chairman, as a former Member of Congress I can tell you that one of the most difficult laws I've ever had to deal with was the "law of unintended consequences". I know you are working to minimize those unintended consequences in this legislation, and I thank you for your attention to this matter.